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SUBJECT: AFGHANISTAN - COCA COLA PLANS LARGE EXPANSION

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SUMMARY

1.(SBU) Kabul's Coca-Cola bottling plant, the flagship U.S. brand name investment in Afghanistan, is moving forward on an $8 - 10 million expansion. The expansion will better position the facility to compete for contracts to supply bottled and canned beverages to U.S. and NATO forces. Coke's growth will be an important symbol of success for both Afghanistan and the United States. Coca-Cola's successful petition to President Karzai yielded a presidential order to raise the tariff on imported beverages from 20 to 40 percent. The GOA also cut tariff rates on inputs to the bottling process from the 10 percent assessed to finished products to 1 percent, based on an importer's written petition claiming the imports are for industrial use. However, the Afghanistan Investment Support Agency makes this determination, not the Afghan Customs Directorate. Because the tariff increase is likely to increase smuggling and decrease revenue, the IMF is insisting that the tariff hike be temporary. The Fund is also insisting that the GOA eliminate the discretionary element to the tariff cut for industrial inputs, because it is likely to increase corruption. END SUMMARY.

COKE - FINDING ITS WAY

2.(U) Kabul's Coca-Cola bottling facility (owned by Habib Gulzar Non-Alcoholic Ltd.), which had its grand opening last September, is poised for an $8 - 10 million expansion. The plan is to expand three key parts of the factory's output by Q1 2008: type of product, size and type of packaging, and quantity of output. After the expansion, the facility will be able to produce bottled water under the brand name Kinley and soft drinks under the brand names of Coca Cola, Fanta, and Sprite in a larger variety of containers (including - 250 ml glass bottles, 330 ml cans, and up to 1.5 L plastic bottles).

After this investment, Coca Cola Afghanistan expects to increase total output as well. Currently, the facility is operating two out of a possible three shifts, six days per week, and it is looking at the feasibility of adding a third shift. Coca Cola Afghanistan employs 250 people - a number that could increase to over 300 once the expansion is complete.

CHALLENGES

3.(SBU) Demand for bottled water and soft drinks is highly seasonal in Afghanistan, and this winter's unusually cold weather, dampened local demand for soft drinks well below the norm. The company also expected to tap into the U.S. military and NATO markets more quickly. According to plant management, Coca Cola Afghanistan recently passed health inspections conducted by U.S. forces. Managers claimed that contracts with both U.S. and NATO forces would be signed upon the successful completion of the expansion.

LOCAL BEVERAGE MANUFACTURERS BAND TOGETHER

4.(U) Reportedly, several companies have recently organized and registered under the name Afghan Beverage Manufacturers Association. Coca-Cola, along with other domestic bottlers, is a founding member. Of the $65 million in total investment in the beverage sector (which includes five major producers of soft drinks and bottled water), Coke licensee Habib Gulzar Non-Alcoholic Ltd. has invested a total of $25 million in production capacity and other investments. Coke's production capacity is nearly 40 per cent (17 million cases) of the sector total. The Afghan Beverage Manufacturer's Association estimates that the total demand is approximately 25 million cases (including bottled water) and there are approximately 2000 direct employees in the sector.

PROTECTIONISM REARS ITS UGLY HEAD

5.(SBU) Coca-Cola management noted that low tariffs on imported beverages and relatively high tariffs on imported production inputs such as bottle caps, labels, and plastic test tube-like objects (which are then heated and formed into bottles) had limited its production operations to one shift working less than six days per week. The GoA had treated these as finished products, even though the facility was using them merely as inputs. The company petitioned the government to create in the Afghan tariff schedule a 1 percent duty on these industrial inputs instead of the 10 percent paid on finished products. The GOA agreed and gave the Afghan Investment Support Agency, not the Afghan Customs Directorate, the authority to determine if an imported good is a finished product or an industrial input, based on an application filed by the importer.

6.(SBU) In a meeting with President Karzai on the margins of the SAARC Summit in Delhi, Coca-Cola, joined by at least one other local bottler, asked the government to raise tariffs on imported beverages to protect local manufacturers. Domestic bottlers, the companies warned, would have to scale back or close unless the GoA took action to promote the Afghan bottling industry. Additionally, Gulzar reportedly pledged that he was ready to make this new $8-10 million investment if the company could be convinced that some of its concerns were being met. After hearing the businesses' complaints, President Karzai directed that the GOA raise the import tariff rate on beverages from 20 to 40 percent. This increase, asserted the bottlers, is reasonable because neighboring countries like Pakistan and Uzbekistan impose tariffs of 57 and 120 percent respectively on imported beverages. (NOTE: The IMF Mission reported before its departure that it will require that the GOA set an expiration date for the new tariff increase for imported beverages and that it eliminate the discretionary aspect of the 1 percent duty valuation for imported industrial/manufacturing raw material inputs. END NOTE).

SMUGGLING

7.(SBU) Domestic bottlers also complain about illicit competition from smuggled bottled water and soft drinks. In addition, Kabul is rife with rumors that beverages intended for consumption by U.S. and NATO forces are being diverted into private super markets. (NOTE: President Karzai's office approached the Embassy for help in controlling these illegal diversions by military suppliers. END NOTE.) Beverages imported for military use are not assessed duty, so they enjoy a considerable cost advantage that seriously hampers the competitiveness of local producers.

PEPSI HURT BY TARIFF RISE

8.(SBU) PepsiCo supplies the Afghan market from bottling plants in Pakistan and the United Arab Emirates, and its exports to Afghanistan have suffered severely from the tariff spike. Last year, under a tariff schedule that imposed tariffs on imported goods at a rate of 20 percent for at least part of the year, PepsiCo paid a total of $4.5 million to the GoA.

COMMENT

9.(SBU) The success of the Coca-Cola bottling plant, currently the largest and most recognizable U.S. brand name investment in Afghanistan, is important an symbol of success for Afghanistan and the United States. However, both the tariff changes that Afghanistan has implemented and the manner in which they were implemented raise serious policy concerns. Given Afghanistan's long and porous border, tariff rates as high as 40 percent are likely to induce smuggling and therefore significantly reduce government revenue. Similarly, the discretionary process through which the quasi-governmental Afghanistan Investment Support Agency determines whether an import is a final product or an industrial raw material

input based on an importer's petition opens the door to potential abuse and corruption. This also complicates the ability of GoA to project its revenues and plan expenditures accordingly. Finally, President Karzai's order to change the tariff rate, reportedly over the objections of his Finance Minister and without reference to parliament, raises serious questions about future political interference in economic policy and Afghanistan's ability to sustain revenue growth in the face of domestic protectionist pressures.

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